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In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division**

Volume 11 Number 2

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IN THIS ISSUE...

- PROPOSED AMENDMENT TO SAS NO. 58 WOULD ELIMINATE THE REQUIRED UNCERTAINTIES EXPLANATORY PARAGRAPH1
- HIGHLIGHTS OF TECHNICAL ACTIVITIES2
- REMAINING 1995 ASB MEETING DATES5
- AUDITING STANDARDS DIVISION STAFF5

PROPOSED AMENDMENT TO SAS NO. 58 WOULD ELIMINATE THE REQUIRED UNCERTAINTIES EXPLANATORY PARAGRAPH

by Judith M. Sberinsky

At its June 1995 meeting, the Auditing Standards Board (ASB) reviewed a proposed amendment to Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. After extensive deliberations, the ASB voted to ballot the draft for exposure. The title of the proposed amendment is *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements*, and it is expected that the exposure draft will be available to the public for comment by July 15, 1995.

Historically, the ASB has not endorsed the requirement that the auditor add an uncertainties explanatory paragraph to the auditor's report if a matter involving an uncertainty is presented and disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). An examination of the evolution of accounting standards dealing with uncertainties will reveal how the uncertainties explanatory paragraph came into being and why it is no longer consistent with current accounting standards.

When Accounting Principles Board Opinion No. 9 (APB Opinion 9), *Reporting the Results of Operations*, was issued in December 1966, it required that financial statements be retroactively restated upon the resolution of certain uncertainties. When such uncertainties existed, applicable auditing standards required that the auditor (1) add a paragraph to the auditor's report explaining the nature of the uncertainty, and (2) qualify the auditor's opinion on the financial statements to state that the opinion was "subject to the effects, if any, on the financial statements of the ultimate resolution of the matter." Because accounting standards required that financial statements be restated after the resolution of an uncertainty,

it was appropriate for the auditor's report to indicate the tentativeness of the statements.

The rationale for the "subject-to" opinion was eliminated with the June 1977 issuance of Statement of Financial Accounting Standards (FASB) Statement No. 16, *Prior Period Adjustments*, which superseded paragraphs 23 and 24 of APB Opinion 9, and prohibited the retroactive restatement of previously issued financial statements upon the resolution of an uncertainty, except in certain limited circumstances.

The issuance of FASB Statement No. 16 and the expanded disclosure requirements for contingencies brought about by the March 1975 issuance of FASB Statement No. 5, *Accounting for Contingencies*, made the subject-to opinion technically incorrect and redundant. The subject-to language was technically incorrect because if matters related to an uncertainty were presented in accordance with FASB Statement No. 5, the financial statements were presented fairly in conformity with GAAP, and the fairness of the presentation was not subject to the outcome of the uncertainty. The additional report paragraph explaining the nature of the uncertainty was redundant because it communicated information already communicated in the financial statements. If that information had been omitted from the financial statements, a GAAP departure would have existed and the auditor would have been required to issue a qualified or adverse opinion, and not a subject-to qualification.

In 1978, the independent Commission on Auditors' Responsibilities (the Cohen Commission) recommended that subject-to paragraphs be eliminated. The Cohen Commission believed that it was difficult for financial statement users to determine whether the auditor's intention in subject-to paragraphs was to highlight information more fully disclosed

elsewhere or to indicate a deficiency in the financial statements. The Cohen Commission also emphasized the need for expanded financial statement disclosures about the risks and uncertainties confronting entities.

In 1988, when SAS No. 2, *Reports on Audited Financial Statements*, was being revised, the ASB proposed the elimination of the subject-to opinion. The Securities and Exchange Commission (SEC) had reservations about the ASB's proposal, and although the subject-to opinion was eliminated in SAS No. 58, it was replaced with a required uncertainties explanatory paragraph. Under the provisions of the new standard, when the chance of a material loss resulting from the resolution of a matter involving an uncertainty was at least reasonably possible, the auditor was required to consider adding an explanatory paragraph to an unqualified report describing the matter giving rise to the uncertainty and indicating that the outcome of the uncertainty could not be determined at the time.

In December 1994 the AICPA's Accounting Standards Executive Committee issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Among other disclosure requirements, the SOP requires that financial statements disclose specified information about significant estimates when certain criteria are met. The criteria in SOP 94-6 for disclosure of information about certain significant estimates are similar to the criteria in SAS No. 58 for consideration of the inclusion of an uncertainties explanatory

paragraph in the auditor's report. Accordingly, when the criteria for disclosure in the financial statements are met, the auditor generally is required to consider adding an uncertainties explanatory paragraph to the auditor's report.

At the October 1994 ASB meeting, members of the ASB pointed out the correspondence between these two sets of criteria and noted that the application of SOP 94-6 would probably result in an increase in the number of reports issued with uncertainties explanatory paragraphs. Even those who believe that the uncertainties explanatory paragraph provides a "red flag" to financial statement users acknowledge that the sudden proliferation of reports with uncertainties paragraphs would diminish their usefulness.

At the October meeting, the ASB voted in favor of considering a revision to SAS No. 58 that would eliminate the required uncertainties explanatory paragraph, and recommended that representatives of the ASB discuss this matter with representatives of the SEC. After discussions with the SEC, the SEC indicated that it would not object to the ASB's consideration of the matter and a task force of the ASB, the Reporting on Uncertainties Task Force, was formed to draft a revision of SAS No. 58 that would eliminate the required uncertainties explanatory paragraph.

The proposed revision of SAS No. 58 would not affect SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, nor would it preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements, as provided for in paragraph 37 of SAS No. 58.

HIGHLIGHTS OF TECHNICAL ACTIVITIES

SAS TASK FORCES

Auditor Communications (Staff Aide: A. LOUISE WILLIAMSON). The task force is studying and evaluating Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, and other auditing and attestation literature dealing with communication responsibilities to determine whether revision of these documents is required. The task force is also evaluating the auditor communication recommendations made by the Public Oversight Board in its report, *Strengthening the Professionalism of the Independent Auditor*, and will recommend any changes to the auditing or attestation literature that may result therefrom. The task force expects to present preliminary issues at the October 1995 ASB meeting.

Auditing Investments Task Force (JUDITH M. SHERINSKY). The task force is revising AU Section 332, *Long Term Investments*, and its interpretation, "Evidential Matter for the Carrying Amount of Marketable Securities," to make the guidance in these documents consistent with Financial Accounting Standards Board Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The revised standard will address the auditor's responsibility for auditing investments (including derivatives) and will include guidance on obtaining and evaluating evidential matter relating to assertions about the existence, ownership, amortized cost, fair value, and classification of investments, as well as

the treatment of gains and losses attributable to these investments. In February 1995, the task force presented an issues paper to the ASB. The ASB directed the task force to continue to work on these issues. The task force will present a revised issues paper and a preliminary draft of the revision to AU Section 332 at the August 1995 ASB meeting.

Electronic Evidence Task Force (A. LOUISE WILLIAMSON). The task force is considering whether existing guidance on evidential matter in the audit and attestation literature requires revision, given that a significant amount of evidential matter is currently in electronic format. The task force will also (1) evaluate how an auditor's responsibility for the detection of material misstatements in the financial statements, including the detection of fraud, may be affected by electronic evidence, and (2) consider whether there is a need for non-authoritative guidance for auditors dealing with electronic evidence. At the June 1995 ASB meeting, the task force presented preliminary issues and proposed revisions to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, and to SAS No. 31, *Evidential Matter*, to reflect electronic evidence considerations. The ASB directed the task force to consult with the Audit Issues Task Force for guidance on issues for which the ASB had not reached consensus.

Fraud (JANE M. MANCINO). The task force is developing a proposed SAS that would supersede SAS No. 53, *The Audi-*

tor's Responsibility to Detect and Report Errors and Irregularities. The proposed SAS would clarify the auditor's responsibility for the detection of fraud and provide operational guidance for carrying out that responsibility. At the June 1995 ASB meeting, the task force recommended that AU Section 110, *Responsibilities and Functions of the Independent Auditor*, be revised to include a statement of the auditor's responsibility for the detection of fraud and that AU Section 230, *Due Care in the Performance of Work*, be revised to include discussions of reasonable assurance and professional skepticism. These concepts are fundamental to a discussion of the auditor's responsibility for the detection of fraud and would provide a foundation for their discussion in the proposed SAS.

Internal Control Guidance (J. ERIC NICELY). The task force is revising SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, to reconcile that document with the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, *Internal Control—Integrated Framework*. An exposure draft that incorporates the COSO Report's definition and description of internal control into the affected SASs and Statements on Standards for Attestation Engagements (SSAEs) was issued in February 1995 with a comment period ending on June 30, 1995.

Reporting on Uncertainties (JUDITH M. SHERINSKY). A task force has drafted an amendment to SAS No. 58, *Reports on Audited Financial Statements*, that would eliminate the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. At the June 1995 ASB meeting, the task force presented a draft of the proposed SAS titled *Amendment to SAS No. 58, Reports on Audited Financial Statements* (No. 800090). The ASB discussed the proposed amendment and voted to ballot it for issuance as an exposure draft. It is expected that the exposure draft will be available for comment from the public by July 15, 1995. Comments on the exposure draft are due by September 29, 1995. To order a copy, write to: AICPA Order Department, CL395, P.O. Box 2209, Jersey City, NJ 07303-2209; or fax your order to 800/362-5066.

SAS No. 59 Guidance (JUDITH M. SHERINSKY). The task force considered issues related to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to determine whether there was a need for additional guidance in the form of an amendment or interpretation of SAS No. 59. A proposed footnote to paragraph 13 of SAS No. 59, prohibiting the use of conditional language in the auditor's conclusion about an entity's ability to continue as a going concern, was included in the exposure draft of the proposed Omnibus SAS/SSAE—1995 that was exposed for comment in February 1995. In addition, the task force has drafted an interpretation of SAS No. 59, "Eliminating a Going-Concern Paragraph from a Reissued Report," that provides guidance on the factors to be considered and the procedures to be performed when determining whether to reissue an audit report on financial statements and eliminate the going-concern explanatory paragraph that appeared in the original report. The interpretation will be published in the August 1995 issue of the *Journal of Accountancy*.

SSAE TASK FORCES

Agreed-Upon Procedures (A. LOUISE WILLIAMSON). The task force considered the performance and reporting guidance in professional standards dealing with agreed-upon procedures engagements. At the June 1995 ASB meeting, the task force presented revised drafts of a proposed SAS titled *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* and a proposed SSAE titled *Agreed Upon Procedures Engagements*, and voted to issue the proposed standards as final standards. It is expected that the SAS and SSAE will be available in the third quarter of 1995. The standards are effective for reports dated after April 30, 1996.

Forecasts and Projections (LINDA VOLKERT/DAN M. GUY). The task force monitors and addresses problems encountered in implementing the guidance in SSAE No. 1, *Attestation Standards*, "Financial Forecasts and Projections." An updated AICPA Audit and Accounting Guide, *Guide for Prospective Financial Information*, was published in March 1993. The task force is in a monitoring mode and no meetings are scheduled at this time.

SEC Auditing Practice (JANE M. MANCINO). In October 1994, the task force issued an exposure draft of a proposed SAS/SSAE titled *Amendments to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties, and to Statements on Standards for Attestation Engagements*. The proposed SAS/SSAE provides reporting guidance and a sample comfort letter for instances when the criteria for the issuance of a comfort letter, listed in paragraphs 4 through 7 of SAS No. 72, have not been met. At its April 1995 meeting, the ASB discussed issues raised in comment letters and voted to ballot the proposed SAS for issuance as a final SAS. The ASB is currently in the balloting process and expects to issue a final SAS in the third quarter of 1995.

APS TASK FORCES AND COMMITTEES

Audits of Small Businesses (J. LOUIS MATHERNE). The Auditing Procedure Study (APS), *Audits of Small Businesses*, is being updated to incorporate the guidance in recently issued SASs and to apply that guidance to audits of small businesses. The revised APS will be available in the third quarter of 1995.

Audit Sampling (J. LOUIS MATHERNE). A task force is developing an APS to replace the Audit and Accounting Guide, *Audit Sampling*. The APS updates the guide for recently issued SASs. The task force expects to issue a final APS in the third quarter of 1995.

Analytical Procedures Task Force (J. LOUIS MATHERNE). The task force is considering topics for inclusion in an APS on analytical procedures. The task force will begin drafting the APS in the third quarter of 1995.

Computer Auditing Subcommittee (JANE M. MANCINO). The subcommittee is working on two APSs. One APS is titled *Auditing in a Client/Server Environment*, and describes client/server computing and its possible effects on the financial statement audit. The subcommittee expects to issue this APS in the fourth quarter of 1995. The other APS deals with electronic data interchange and its possible effects on the

financial statement audit and was drafted with the Canadian Institute of Chartered Accountants. The subcommittee expects to issue this APS in the fourth quarter of 1995.

SAS No. 70 Auditing Procedure Study (JUDITH M. SHERINSKY). The task force has drafted an APS that provides guidance to auditors on implementing SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*. The APS provides guidance to a service auditor engaged to issue a report on the control structure policies and procedures of a service organization. It also provides guidance to user auditors engaged to audit the financial statements of an entity that uses a service organization. An example of a service organization is a bank trust department that invests and holds assets for employee benefit plans. The task force expects to issue the APS in the third quarter of 1995.

OTHER TASK FORCES AND COMMITTEES

Audit Issues Task Force (J. ERIC NICELY). The task force meets on a monthly basis to assist the ASB Chair and the Auditing Standards Division staff with the technical review of audit issues. After review of such issues, the task force determines whether they require ASB attention.

Control Risk Audit Guide Revision Task Force (J. ERIC NICELY). The task force is proposing conforming changes to the Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, resulting from the proposed amendment to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. The proposed amendment to SAS No. 55 reconciles the SAS with the Committee of Sponsoring Organizations of the Treadway Commission's Report, *Internal Control—Integrated Framework*. The revised guide is expected to be released simultaneously with the issuance of the SAS No. 55 amendment.

Environmental Issues Task Force (JUDITH M. SHERINSKY). The task force has drafted a chapter titled "Auditing Environmental Remediation Liabilities" that is included as an appendix in the Accounting Standards Executive Committee's proposed SOP, *Environmental Remediation Liabilities* (No. 800091). The guidance presents the recommendations of the task force regarding the application of generally accepted auditing standards to the audit of an entity's financial statements as it relates to environmental remediation liabilities.

The exposure draft of the proposed SOP was issued on June 30, 1995, with a comment deadline of October 31, 1995. To order a copy, write to: AICPA Order Department, CL695, P.O. Box 2209, Jersey City, NJ 07303-2209; or fax your order to 800/362-5066.

The task force is also responsible for evaluating, on an on-going basis, the need for auditing or attestation guidance related to environmental matters and for monitoring related activities of other standard-setting bodies.

Joint Task Force on Quality Control Standards (DALE R. ATHERTON). The task force has drafted two proposed standards that would supersede Statement on Quality Control Standards No. 1, *System of Quality Control for a CPA Firm*, and its interpretations. The first standard, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, is a general standard that requires a CPA firm to have a system of quality control for its accounting and auditing practice. It describes the elements of quality control and other matters essential to the effective implementation of the system. The standard proposes that the current nine quality control elements be restructured into the following five elements: independence, integrity and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring. The second standard, *Monitoring a CPA Firm's Accounting and Auditing Practice*, provides guidance on how a CPA firm can implement the monitoring element of a quality control system in its accounting and auditing practice. The ASB discussed the proposed standards at its June 1995 meeting, and unanimously voted to ballot the proposed standards for exposure, with the understanding that certain suggested revisions would be made to the documents.

9000 Review Task Force (J. ERIC NICELY). The task force has proposed revisions to various sections of the audit and attestation literature and included those revisions in a proposed Omnibus SAS/SSAE—1995 that was exposed for comment in February 1995 with a comment period ending on June 30, 1995. The task force is also developing several interpretations of the SASs. The task force receives assignments, on an on-going basis, from the Auditing Standards Division staff and the Audit Issues Task Force and will meet in July 1995 to discuss some of those issues.

REMAINING 1995 ASB MEETING DATES

August 1-3, 1995
(Colorado Springs, CO)

October 10-12, 1995
(New York, NY)

November 14-16, 1995
(New York, NY)

December 12-14, 1995
(New York, NY)

Auditing Standards Board meetings are open to the public. For information about the ASB meeting agenda, call the AICPA toll free at 1-800-TO-AICPA.

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